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C O N F I D E N T I A L SECTION 01 OF 03 MOSCOW 005571

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SUBJECT: RUSSIA: POWER SECTOR RESTRUCTURING ENTERS LAST
STRETCH

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Classified By: Ambassador William J. Burns for reasons 1.4 b and d.

Summary

11. (SBU) The electricity sector's regulatory and policy framework after July 2008, when holding company RAO UES will cease operations, is taking shape. On October 26, RAO UES shareholders approved the restructuring plan and consented to the appointment of RAO UES' director of strategy as the new head of the Ministry of Industry and Energy's Energy Agency (Rosenergo). These measures set the stage for the transfer of responsibility over Russia's power sector reform from RAO UES to the government and a new industry organization, the

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Market Council. Strategic players in Russia's post-UES power sector have started to emerge, including Gazprom, SUEK (Siberian Coal and Energy Company), Norilsk Nickel, and Interros. In addition, a few foreign companies have purchased significant, but not controlling stakes, in RAO UES daughter companies. There is concern among economic liberals at Gazprom's entry into the market. There are also concerns that rising inflation may cause delays in price liberalization. End summary.

Rosenergo Takes Over

12. (SBU) An October 26 RAO UES shareholders meeting approved the company's restructuring plan. After July 2008, Rosenergo will retain RAO UES' authority to regulate the power sector. It was also agreed in the October shareholder's meeting that Dmitriy Akhanov, former RAO UES director for strategy and architect of UES' restructuring, would be appointed head of Rosenergo. Speaking at the November 13 UBS Russian Investors' Conference, RAO UES CEO Chubays said that Rosenergo would be the government body responsible for development of the power sector post-July 2008. Akhanov, speaking as the new Rosenergo head, told the press on November 20 that, "the sector requires regulation, in the best sense of the word, since liberalization of the market cannot succeed without clear rules and mechanisms." Specifically, he said Rosenergo's responsibilities would include technical regulation, control over the market's overall health, forecasting, and strategic questions.

Market Council

13. (SBU) Also part of the restructuring plan is a new structure, the Market Council, which will represent the power industry's producers, customers, and government representatives, and will perform oversight functions in the sector, including setting policies for new entrants and reviewing regulations in the wholesale power market. The Administrator of the Trading System (ATS), the non-commercial RAO UES daughter company which has been overseeing the scheduled movement of regulated wholesale power sales from long-term contracts to a wholesale spot market, is to be placed under the Market Council. By mid-2007, 90 percent of wholesale power sales were conducted through long-term contracts. ATS Deputy Chairman Shkatov told us in August that ATS will conduct 100 percent of wholesale power sales in the spot market by 2011. (N.B. This corresponds to the GOR announced plans to completely liberalize wholesale power prices by 2011.)

14. (SBU) According to Shkatov, the plan is to create two market pricing zones in the Russian Federation. The first zone would encompass the European and Ural regions and the second zone would encompass the Siberian region. A third zone includes regions in which the state will continue to regulate electricity prices: the Far East, Komi Republic, Archangelsk, and Kaliningrad regions. According to ATS, these regions are isolated from UES' main networks and cannot be incorporated into the wholesale pricing system.

Power Generation Privatization

15. (SBU) On November 13, Chubays reaffirmed that RAO UES'

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restructuring and privatization of its component daughter companies is to be completed by April 2008. He said that UES has already raised \$20 billion by selling stakes in its 20 restructured power companies, the six Wholesale Generating Companies (WGSSs) and 14 Territorial Generating Companies (TGCs), and is expected to raise another \$20 billion by April 2008 through further sales.

16. (SBU) As privatization has accelerated over the past year and a half, strategic players in Russia's post-UES power sector have started to emerge. Gazprom, SUEK (Siberian Coal and Energy Company), Norilsk Nickel, Interros, and Integrated Energy Systems (IES) are some of the Russian companies with controlling stakes in UES' generation companies.

17. (C) In addition, foreign players have also been allowed to purchase large stakes in UES' daughter companies. However, though UES officials have assured us that foreign companies can buy controlling stakes in these companies, Germany's E.ON and Italy's Enel, to date, have not been able to complete their planned buy-out of minority shareholders in their respective companies. The experience of Finland's Fortum showed that some power companies, such as TGC-1 in the St. Petersburg region, might be too "strategic" for foreign ownership (reftel). Despite these limitations, other foreign companies, including Gaz de France and Korea's Kepco, have also recently expressed interest in purchasing power generation assets.

GOR Keeps Infrastructure

18. (SBU) Under the restructuring plan, the GOR will retain control over much of the power sector's infrastructure. The Federal Grid Company (FGC) will continue to be 75 percent state-owned. The company owns and operates the long distance high voltage (500 KW and higher) transmission network. Part

of the sale of the state's stake in the WGSs and TGCs will be used by the FGC for capital investment. The Inter-regional Transmission Company, which has the high voltage transmission lines interlinking the regions, will also be a separate state-owned company. The local transmission networks, however, which make up the regional low voltage distribution network (250 KW and lower), will be privatized.

¶9. (SBU) The GOR will also retain control or 50 percent plus one share over the Hydroelectric Wholesale Generating Company (Hydro-WGC) after restructuring is completed. The company includes all of RAO UES' 19 hydroelectric plants, which produced 13 percent of Russia's electricity in 2005 (embassy calculations). According to ATC, Hydro-WGC is a member of the wholesale market and will participate in both market price zones.

¶10. (SBU) Inter RAO is another state-controlled company that will be spun-off after July 2008. In 2001, RAO UES consolidated all its electricity import and export operations under Inter RAO. Currently, Inter RAO is 60 percent owned by RAO UES and 40 percent owned by Rosenergoatom, the other major electricity exporter, and is viewed by many industry observers as the GOR's "national champion" in the power sector. It owns power assets in the Commonwealth of Independent States, including Kazakhstan, Armenia, Georgia, Moldova, and Tajikistan. Inter RAO has also attempted to acquire power assets in Slovakia and Turkey.

Gazprom Crashing the Party

¶11. (SBU) The increasing footprint of Gazprom in Russia's power sector has caused concern among many reform backers, including RAO UES CEO Chubays, Federal Anti-Monopoly Service (FAS) Head Artemyev, and former Economic Development and Trade Minister Gref (see reftel). Having already acquired control of TGC-1 and TGC-3 (Mosenergo), the local power producers in the St. Petersburg and Moscow regions, Gazprom has its eyes set on acquiring stakes in a half of dozen other TGCs and WGCs. Also hanging over the reform is Gazprom's proposal to merge its power assets with SUEK's significant Siberian power assets. Industry observers tell us that the deal has been put on hold because of strong opposition from the GOR's economic liberals, but has not been shelved.

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FAS: Gazprom Counterweight

¶12. (SBU) Analysts have noted that Chubays and other reform supporters may be pinning their hopes on FAS to ensure competition in the developing wholesale power market. FAS introduced changes to the November 4 amendment to the law "On the Electric Power Sector" to keep concentration of market power out of Gazprom's hands. According to the amendment, a market share of more than 20 percent of generation capacity, instead of the previously stipulated 35 percent, could be considered a dominant or non-competitive position. Article 25 of the law gives FAS the authority to rectify non-competitive behavior in price formation or fuel supplies in a given wholesale market.

Comment

¶13. (C) Post-July 2008, the GOR will formally wield control over the sector's development through Rosenergo and representation on the Market Council. Informally, the GOR will also continue to wield influence through control over much of the power sector's infrastructure. One U.S. expert on reform of natural monopolies told us that the GOR still

has not reconciled its different price liberalization schedules for wholesale and residential markets. Wholesale electricity prices are set to be 100 percent liberalized by 2011 but residential electricity prices are set to be liberalized only in 2014. If the GOR follows through with its scheduled price liberalization, the government would have to subsidize residential power prices, which make up 20 percent of annual power consumption, until both markets are fully liberalized. However, the more likely scenario is that an inflation-adverse government will pull the plug on scheduled increases in power prices in the near-term, wholesale and retail, if power prices look to likely to spill over into the overall inflation rate and will continue to subsidize both sectors.

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